CENTRAL BANK :-

=> An apex banking and monetary institution which controls, regulates and stabilizes the banking and monetary system of the country is called the Central Bank.

=> It basically controls the banking system and the money market of the economy.

=> Reserve Bank of India is the Central Bank of our Country.

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NEED FOR A CENTRAL BANK :-

(1) Maintenance of Economic Stability :-

↳ Value of Money;
→ Foreign Exchange Rate;
→ Inflation Control;

(2) Supply of Money & Bank Credit :-

↳ Controlling the inflation & deflation through the increment or decrement of the supply of credit in the economy.

(3) Maintenance of Exchange rate in Domestic Country

↳ Through the proper use of the foreign exchange according to the need of the country.

(4) Maintenance of International Equilibrium:-

↳ Make the atmosphere of healthy competition so that the entrepreneur can engage in mutual healthy competition in the home market & foreign market;

(5) Creation of Environment for the Establishment of the Commercial Bank :-

↳ Establishment of well organized banking system;

→ It follows upto date rules; regulation and other policy so that appropriate banking system can develope.

(6) Special Role in Developing Economy:-

=> In developing country; it playes an important role through the appropriate arrangement of

(a) bank credit; → for Agriculture; Industry;
(b) incentive for saving;
(c) Collect the public debt;

RESERVE BANK OF INDIA (RBI):-

=> It is an apex monetory institution of India;

=> It was establish for :-

(a) Stabilization of Economic base;
(b) Increase the rate of economic development;
(c) Proper guidance in monetory system;

Establish under Reserve Bank of India Act; 1934;
Start functioning from 1st Apr; 1935
After independence it was nationalized on 1st January; 1949.

Departmental Structure Of RBI:-

=> Issue Department:-

Function:- Related to issue of Notes;

Established at 1st Jan; 1949

=> Department of Banking Operation and Development:-

Function:- To organise and develope the bank related other functions;

=> Agricultural Credit Department:-

NABARD
National Bank for Agriculture & Rural Development

Function:- (1) Research related to agricultural Credit;
(2) Issue agricultural Credit;
And Consideration of those matters related to agricultural Credit

Functions under NABARD

Established in 1982

=> Department of Supervision:-

Established in December 1993.

Functions:- (1) Organise the activities of Schedule Commercial Banks; Other dept. of RBI
(2) Supervision of the activity of other financial institutions & non banking institutions;

FUNCTIONS OF RBI:-

The basic functions of Reserve Bank of India are:-

(1) Monopoly Power Regarding Issue Note:-

Amendment of Reserve Bank of India Act; 1957

RBI can print note at any amount by depositing minimum securities on gold worth of ₹115 Cr & foreign exchange of the amount of ₹85 Cr. (Total is ₹200 Cr.);

Any special situation the bank can print any amount notes by depositing only gold worth ₹115 Cr.

This is known as "Minimum Reserve System"

⇒ Only the power to issue note of all denominations except one rupee note.

⇒ The one rupee note and coin are issued by Ministry of Finance; GOI.

⇒ Issue department determines the size of the notes of different denomin-ations and other structural process by taking the permission of central govern-ment.

(2) Function As A Banker Of Government:-

It give the advances to remove the time gap among the collection of revenue and expenditure of the government.

⇒ (a) Revenue collection of government;
(b) Government expenditure disbursement;
(c) Keeping all the types of government money balance;
(d) Give short term loan to the govern-ment;
(e) Organise public debt;
(f) Give all types of financial advice to the government;
(g) Act as an agent of the government in the financial matter;

(3) Function As A Banker of Other Banks:-

⇒ Schedule commercial banks of the country Compulsary keep a fixed part of their deposit with the Reserve Bank of India; This ratio is called Reserve Ratio;

e.g: April 1984 – 9%.;
August 1994 – 15%.;
January 2004 – 4.5%.;
January 2005 – 5%.;
April 2010 – 6%.;
March 2012 – 4.75%.;

At present it can increase the cash reserve ratio upto 20%.

⇒ At emergency, RBI can give the credit to the commercial bank by depositing Short term security; (Lender of Last Resort)

CLEARING HOUSE

⇒ To meet up the mutual assets and liabilities of different banks

RBI ⇒ Controller & Supervisor of all banks with respect to the establishment of new banks; new branches; merger of banks; decision of bank office (house) close; restructure of banks;

(4) Determination of Exchange Rate of Rupee with Other Foreign Currency:-

⇒ Declare the exchange rate of foreign currency with Indian rupee;

⇒ Moreover; take the necessary steps to Steabilize the exchange rate.

⇒ Organise accmulated gold and foreign exchang reserve for its proper utilization;

⇒ Coordinate the function with other international financial institutions [and with International Monetary Fund (IMF)]

(5) Enquires And Survey:-

=> Collect the financial information from enquiries & survey.

=> Publish all information through systematic way in regular interval:-

Soft version:
- Publish all in website.
  www.rbi.org.in.
  (1) Database on Indian Economy
  (2) Handbook of Statistics.

Print copy:
- (a) Annual Report;
- (b) Report on Trends & Progress of Banking in India;
- (c) Monthly Bulletin;
- (d) Annual Report on Currency & Finance.

(6) Credit Control :-

Controlling the commercial Credit:

=> RBI tries to regulate the fluctuation of price level and the fluctuation of economic growth rate through the quantitative and qualitative methods of Credit Control;

(7) Development Function :-

(i) Industrial Finance Corporation of India (IFCI)

(ii) Industrial Credit And Investment Corporation of India (ICICI)

(iii) Industrial Development Bank of India (IDBI)
=> Promote Industrial Finance for Industrial Development

(i) National Bank For Agriculture & Rural Development (NABARD) => Promote Agricultural Finance for Agricultural Development;

(i) Export Import Bank (EXIM Bank) => Promote Credit & other facilities for foreign trade;

(i) National Housing Bank Under National Housing Corporation;

=) Established for the development of housing Sector in country;

These are the institutes developed by RBI to increase the development work in the economy.

(8) Supervisioning Function :-

=) Done supervision on commercial banks according to banking regulation act through the certain unit, named "Department of Supervision".

=) Thus it is seen that the functions of the RBI are Multipurpose;

Policy Of RBI :-

=) RBI has the authority to control the money supply in the economy;

=) This is known as the monetary policy;

=) RBI basically controls the money supply by Controlling the Credit supply in the economy. Therefore it is known as "Credit Control Policy".

Need to Control Money Supply :-

(i) For the expansion of economic growth & development

(ii) To maintain the general price level of the economy. (Controlling the inflation);

⇒ RBI basically control the amount of Credit Supply in the economy by controlling the rate of interest;

Credit Expansion by RBI:-

(1) During Second Five Year Plan RBI increased money supply by implementing Reserve Bank of India Act; 1957 (Amendment);

(2) Increased Money Supply through the introduction of export bill in bill market in 1947;

(3) Introduction of "Special Advantage" for some Sectors in 1965 (Cooperative Society; Small Industry)

(4) Follow Judicial Liberal Policy for Credit from 1965;

(5) Introduction of new bill market Scheme in 1970; (Allowing the larger amount of money for Schedule Commercial bank);

(6) Reduction of bank rate (rate of interest of Central bank) in March; 1998; April 1998; April 1999 etc;

(7) By reducing the Reserve Ratio (Certain amount of money in relation to the volume of their deposit) of commercial bank in January; 2004; March 2012.

(8) By decreasing Statutory Liquidity Ratio (SLR) in January 2001; February 2013.

$$SLR = \frac{\text{Liquid Cash in hand.}}{\text{total deposit}}$$

=> The basic problem of the credit expansion policy is: It helps to increase the inflation rate in the economy. Therefore to check the inflation rate in the economy, Some times the RBI took Some Credit Contraction policy.

Credit Contraction Policy:-

=> (1) By increasing the bank rate in the economy.

Bank Rate in 1951 => 3.5%.
in 1963 => 4.5%.
in 1971 => 6%.
in 1981 => 10%.
in 1991 => 12%.
} ↑es.

in 2006 => 6% ↓es. (why?)

(2) By increasing cash reserve ratio in the economy.

CRR in 1962 => 3%.
in 1973 => 6%.
in 1981 => 7%.
in 1984 => 9%.
in 1988 => 11%.
in 1989 => 15%.
} ↑es

(3) By increasing SLR in the economy;

SLR in 1962 => 25%.
in 1965 => 30%.
in 1973 => 40%.
in 1994 => 39%.
in 2012 => 24%.
} ↑ing (1962 - 1973)

decreases (↓)

(4) Using some qualatative methods in 1956;

=> (1) Regulation of Margin;
(2) Discriminatory Bank Rate;

(5) Introduction of Credit Authorization Scheme in the economy;

=> Limit of credit issue was fixed in this Scheme; The commercial bank can not give credit any amount to their creditor;

Therefore the basic objectives of the RBI are:-

Policy Statement - 2005-06

(1) Maintain Price Stability;
(2) To support export & investment demand;
(3) To provide appropriate liquidity to meet genuine credit needs of the economy;

Policy Report - 2006-07

(4) To ensure a monetary and interest rate environment that enables continuation of growth momentum with price stability;
(5) To focus on credit quality and financial market conditions to support the export and investment demand in the economy for maintaining the economic and financial Stability;
(6) To respond rapidly for evolving the global development.

Ref : Indian Financial System And Financial Market Operations
— Ajay Kr. Nandi

A Special Note On "Credit Control Policy By Central Bank":-

=> A procedure which central bank takes to control the credit which is created by the commercial banks is called the credit control policy of the central bank.

=> The basic objective of the credit control policy is to control the inflation in the economy.

=> Two methods of credit control policy are :-
(i) Quantitative Methods of Credit Control;
(ii) Qualitative Methods of Credit Control or Selective Method of Credit Control;

(i) Quantitative Methods Of Credit Control:-

=> The process by which the central bank changes the total amount of credit or total supply of credit of the commercial banks of the country;

=> It can be devided into three groups:-
(a) Bank Rate; (b) Open Market Operation; (c) Variable Reserve Ratio;

(a) Bank Rate:-

=> The minimum rate at which the central bank of any country is willing to rediscount first class bills offered by the commercial banks to give the loans to the commercial banks is called bank rate.

=> It is the rate of interest of the central bank;

Rediscount Bills:-

=> The reduction in the value of any commodity; e.g by depositing securities of Rs. 100/- at any commercial bank if Rs. 90/- is received then the rate of discount is 10%. If the commercial bank received money by depositing that securities again with the centra

bank then that securities is rediscounted; i.e discounted securities of one time if discounted another time then it is re-discounted; Here the central bank applies it own discount rate for rediscounting bill;

=> During the inflation, the central bank increases the bank rate to reduce the supply of credit in the economy and during the deflation central bank reduces the bank rate to increase the supply of credit in the economy;

PROCESS / MECHANISM

Inflation

Bank Rate ↑ => Commercial Bank will take loan from central bank at less amount;

=> Commercial Bank will increase the market rate of interest in the economy;

=> Reduces the credit supply in the economy => Money supply will fall => Rate of inflation will decrease;

(b) OPEN MARKET OPERATION:-

=> Purchase & sale of government securities in the open market by the central bank of the country is called open market operation;

=> During inflation the central bank sales the government securities and the person who purchased it, have to pay money. Therefore the money come to the hand of central bank. So it reduces the money in the economy. The inflation rate reduces as a result of it;

=> The reverse will happen in the case of the deflation in the economy;

(C) VARIABLE RESERVE RATIO:-

⇒ By Law or Convention Commercial banks of the country have to keep certain amount of money in relation to the Volume of their deposits with the central bank. The rat-io is called reserve ratio. Central bank of the country Changes the ratio from time to time. For this it is called Variable reserve ratio.

⇒ During the inflation the central bank increases the Variable reserve ratio. As a result the commercial ba-nk have to keep the higher amount of reserve in the Central bank. Therefor it reduces the Credit supply by the commercial bank in the economy. As a result it reduces the rate of inflation in the economy.

⇒ During the time of deflation the reverse mechanism (reduction of variable reserve ratio) of inflation is taken.

LIMITATION OF QUANTITATIVE METHODS:-

⇒ It is essential to close relation among bank rate and market rate of interest for success of bank rate policy. But in reality, it is seen that market rate of interest is not change along with the change of bank rate.

⇒ Even if it is assumed that market rate of interest is Changes along with the change in bank rate, in Spite of the amount of Credit may not be changed. Be-cause the amount of Credit depends on many other things along with interest rate.

=> If the commercial bank have sufficient amount of excess reserves then they may not feel the credit of the central bank. In this situation, bank rate policy will not be effective;

=> Open market operation can not be successful if the money and credit market are not developed and well organized.

=> Open market operation can not be worked properly if the sufficient amount of government securities is not available at the disposal of central bank.

=> If the commercial banks have sufficient excess reserve the the amount of the credit of the commercial banks can not be reduced by selling government securities in the market.

=> Variable Reserve Ratio is discriminated in action. This can not influence all the banks equally. Actually the financially weak banks are badly affected due to the application of this process.

=> If the commercial banks have sufficient amount of excess reserves then the power of the credit creation of the commercial banks is not reduced by the increment of the variable reserve ratio.

=> Different reactions are created in business world due to change in variable reserve ratio. As a result an uncertainty is created in the security market.

=> All the methods of quantitative credit control is weak due to time lag; i.e. long time is required to become effective for these process;

=> A general defects of all three quantitative methods of credit control is that it can not solve the localised problems quickly;

(ii) Qualitative Methods Or Selective Methods Of Credit Control :-

=> The policy of the central bank to control the credit of selective sectors and to expand the credit of the selective sectors within the country is called qualitative methods or selective methods of credit control;

=> This methods seeks to change the distribution of credit between the various sectors.

=> The most important groups of this methods are discuss below:-

(a) Regulation Of Margin :-

=> The amount of liquide money deposited by the creditor at the time of taking credit by mortgaging share or debenture is called margin.

=> If the margin of any credit is 30%, then the creditor gives 30% in cash and remaning 70% can get from the bank credit;

=> Central bank increases this amount of margin if the central banks wants to reduce the amount of creditor in speculative activites.

=> On the other hand central bank decreases the amount of margin if the central bank wants to reduce the amount of credit in speculative activites;

Control Credit Which Is Used For Speculative Activities;

(b) Regulation Of Customer Credit :-

=> Credit from the commercial banks is available to purchase durable consumer goods (motor car; TV). To purchase these commodities some amount of money in cash is first given and the rest is paid through few instalments.

=> Central bank imposes some restrictions on this type of credit through the process of selective method of credit control.

=> During the time of inflation, the central bank tries to reduce the amount of credit and the number of instalments to demotivate the consumer.

=> The reverse steps has been taken by central bank at the time of deflation;

(c) Discriminatory Bank Rate :-

=> To increase the amount of credit in some special sectors through discriminatory bank rate, central bank decreases the bank rate for the securities of those sectors

=> On the other hand, to decrease the amount of credit in some other sectors, central bank increases the bank rate for the securities of those sectors.

(d) Rationing Of Credit :-

=> Through this selective method the central bank of the country can lay down the different credit quota for commercial banks;

=> Apart from this, the possible amount of credit which the commercial banks can get from the central bank is also fixed by this process;

=> E.G: Central bank can give order to commercial banks regarding the maximum amount of credit of the particular industry can get.

(e) Moral Suasion :-

⇒ In few cases the central bank of the country may request commercial banks to increase or decrease the amount of credit. Commercial banks of the country give due respect of this request as central bank is the apex banking and monetary institution of the country and protect the commercial bank at the time of crisis.

⇒ Central bank of the country apply this process on the expectation that the commercial banks give due respect of this request even though the commercial banks have no legal obligation to obey the request;

(f) Direct Control :-

⇒ Central bank of the country may takes punitive measures against those commercial banks whose functions are against the economic development of the country and the monetary policy of the country. The arrangement is called direct control. In this case, the central bank may stop the exchange of government securities with that commercial bank and some cases, may stop the advances of that commercial bank.

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It can be said that the different types of selective methods of credit control are used in different countries and in different economic situations.

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Limitations Of Qualitative Methods :-

=> It is very complecated method. It is essential to control not only the commercial banks, other Credit issuing institutions should also be controlled for the success of this method. But that is very complicated task.

=> In this method, there is no procedure to determine what purposes the credit money is spend. As a reasult of this method can be in effective by collusion among speculators and commercial banks.

=> For the success of this method it is essential that the commercial banks abide by the guidelines prescribed the central bank. But this condition does not exist in the developing country like India.

=> Sometimes it is very difficult to determine in which sectors the method will apply. As a reasult, it is not always possible to apply this method properly.

=> Amount of money can not be controlled through this process; For this the method can not functions properly to control inflation & deflation;

=> Credit market should be organized for the functioning of this method. But in developing country like India; Credit market is unorganised. As a result of this method, can not function properly in the developing countries.

=> Selective method of Credit Control increases administrative problem and also increases the administrative cost. As a result commercial banks are reluctant to apply this method for the fear of reducing profit.

⇒ Many are of the views that the scope of corruption is too large in this method. This process can not function properly in developing countries like India where corruption is too much.

⇒ In selective methods of credit control, same type of order is issued upon all the commercial banks; Cautious and clever commercial banks are not badly affected by this type of order; but the banks which are not cautious and clever are badly affected for obeying this type of order.

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REF:- INDIAN FINANCIAL SYSTEM AND FINANCIAL MARKET OPERATIONS

— AJOY KR. NANDI

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